

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,

Complainant,

v.

AMERICAN WATER RESOURCES,
INC.,

Respondent.

DOCKET NO. UW-031284

DOCKET NO. UW-010961

DOCKET NO. UW-031596
(consolidated)

INITIAL BRIEF ON BEHALF OF COMMISSION STAFF

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I. INTRODUCTION

1 This case presents two distinct cases for consideration: (1) an evaluation of rates for American Water Resources, Inc., (AWR or Company) in Docket Nos. UW-031284/UW-010961 (consolidated) and (2) a penalty assessment against Virgil Fox individually as AWR's president in Docket No. UW-031596. Staff's analysis reveals AWR's current rates are excessive and should be reduced. Staff also recommends the Commission deny Mr. Fox's request for mitigation of the penalty assessment.

A. Rate Case – AWR

2 The Commission reopened Docket No. UW-010961 and entered a complaint against AWR's rates on August 13, 2003, prompting the evaluation of AWR's rates.¹ The Commission's Order Approving Settlement Agreement in Docket No. UW-010961 anticipated an evaluation of AWR's rates at this time.²

3 The goal of the complaint, as with any rate proceeding, is to set fair, just, reasonable, and sufficient rates for AWR. The Commission accepted a partial settlement agreement between Staff and AWR under which AWR agreed to reduce its rates by \$4.40, the amount ordered in Docket No. UW-010961 to be set aside in a

¹ *WUTC v. American Water Resources, Inc.*, Docket Nos. UW-031284/UW-010961 (Consolidated), Order No. 01, Order Reopening Docket / Complaint Against Rates (August 13, 2003).

² Ward, Ex. 45, *WUTC v. American Water Resources, Inc.*, Docket No. UW-010961, Order Approving Settlement Agreement at ¶ 22 (December 18, 2001) (Order Approving Settlement Agreement). AWR was required to file a rate case no later than December 18, 2003. Arguably, the complaint against AWR's rates released the Company from that obligation. See Docket Nos. UW-031284/UW-010961 (Consolidated), Tr. 11:19 to 12:11; *WUTC v. American Water Resources, Inc.*, Docket Nos. UW-031284/UW-010961 (Consolidated), Order No. 04, Prehearing Conference Order at ¶ 7 (September 16, 2003).

separate account, and to provide refunds to customers.³ Based on financial information AWR provided, a further reduction in rates is warranted.

4 Issues remaining in this proceeding pertain to treatment of Docket 010961 Account funds, treatment of gain from sales of the View Royal and Birchfield water systems, and setting the appropriate level of employee expenses including the number of employees and officer salary.⁴

5 Staff's case is based on sound regulatory principles. Utility investors are entitled to the opportunity to earn a fair return *on* and a return *of* plant prudently devoted to public service, and utilities are entitled to recover prudently incurred and reasonable expenses. Also, a regulated utility is required to share the gain from asset sales with its ratepayers according to a benefit-burden analysis.

6 Staff recommends the Commission order AWR to lower its rates by \$100,555 annually, which results in decreasing AWR's average monthly residential rate from \$33.07 to \$27.38.⁵ In forming its recommendation, Staff used numbers provided by AWR, adjusted for known and measurable changes.

³ *WUTC v. American Water Resources, Inc.*, Docket Nos. UW-031284/UW-010961 (Consolidated), Order No. 05, Order Approving and Adopting Partial Settlement Agreement (October 1, 2003).

⁴ Other, more minor issues also remain in this proceeding and are addressed in this brief.

⁵ This is a slightly different recommendation from the position stated in response to Bench Request No. 1. *See* Staff, Ex. 206. The difference is due to information established during the hearing concerning the Birchfield water system. Staff's treatment of the gain on the sale of Birchfield, which incorporates that information, is discussed under section III.C.1. of this brief. The effect of the new information is reflected in Attachment 1 to this brief, which is an updated Results of Operations.

B. Penalty Assessment – Mr. Fox

7 The Commission issued a penalty assessment of \$3,700 against Mr. Fox in his individual capacity on October 22, 2003, in Docket No. UW-031596.⁶ The penalty resulted from Mr. Fox's role in the violations involving AWR's Docket 010961 Account.

8 The Docket 010961 Account was established in Docket No. UW-010961, in which the Commission ordered AWR to set aside \$4.40 from each customer bill, place the funds into a separate account, and use the funds only for costs associated with the two additional employees AWR claimed it needed.⁷ As president and sole decision-maker for AWR,⁸ Mr. Fox was responsible for ensuring AWR complied with the Commission's Order Approving Settlement Agreement. He failed in that responsibility and now admits the violations occurred.⁹

⁶ *In the Matter of the Penalty Assessment Against Virgil R. Fox, President, AWR, in the amount of \$3,700, Docket No. UW-031596, Notice of Penalties Incurred and Due for Violations of Commission Order, Order No. 01 (October 22, 2003) (Penalty Assessment Order). Docket No. UW-031596 was ultimately consolidated with the complaint against rates, Docket Nos. UW-031284/UW-010961 (Consolidated). WUTC v. AWR, Docket No. UW-031284/UW-010961 (Consolidated), Order No. 07, Order of Consolidation; In the Matter of the Penalty Assessment Against Virgil R. Fox, President, AWR, in the amount of \$3,700, Docket No. UW-031596, Order No. 02, Order of Consolidation and Prehearing Conference Order (February 2, 2004).*

⁷ Ward, Ex. 45, *WUTC v. AWR*, Docket No. UW-010961, Order Accepting Settlement Agreement, ¶¶ 6-8, 18-22.

⁸ Fox, Tr. 318:1-5.

⁹ *Penalty Assessment Against Virgil R. Fox, President, American Water Resources, Inc.*, Docket No. UW-031596, Application for Mitigation of Penalties at ¶ 1 (November 6, 2003); Fox, Ex. 120-T at 46:9-11.

9 The key issue in Docket No. UW-031596 is not whether violations occurred,
but whether Mr. Fox has offered sufficient mitigating factors to justify reducing or
eliminating the penalty. He has not.

10 Mr. Fox argues the penalty should be “dropped” because “the infraction
occurred after thorough and thoughtful discussion with the company’s accountant
and attorney,” and he “had no malicious intent.”¹⁰ Mr. Fox also argues punishment
is appropriate when violations occur out of “sheer ignorance,” but not from careful
deliberation.¹¹ However, the careful deliberation makes Mr. Fox culpable.

11 Mr. Fox blames Staff for the violations resulting in the penalty.¹² However,
Staff did not cause the violations to occur. Mr. Fox also claims he had no choice but
to violate the Commission’s order. However, he had options available other than
committing the violations.¹³

12 None of Mr. Fox’s asserted mitigating factors are sufficient to reduce or
eliminate the penalty. Therefore, the Commission should deny his application for
mitigation and order the entire amount of the penalty be paid.

II. LEGAL STANDARD AND GOVERNING PRINCIPLES

13 **Rate case.** RCW 80.04.110 allows the Commission to file a complaint against
a water company challenging the reasonableness of that company’s schedule of

¹⁰ Fox, Ex. 120T at 46:9-11, 46:21-22, and 47:2.

¹¹ Fox, Ex. 120T at 46:8-11.

¹² Fox, Ex. 120T at 46:23 to 47:1.

¹³ Fox, Ex. 120T at 46:12-13.

rates or charges. Staff carries the burden of proof to show AWR's current rates produce an excessive return *vis a vis* its rate base and prudent, reasonable operating expenses. Staff must demonstrate that the proposed rate is fair, just, reasonable, and sufficient. Rates are traditionally set to allow recovery of prudent and reasonable operating expenses and by applying a fair rate of return to a depreciated original cost rate base.

14 Investors devote capital, not individual assets, to public service.¹⁴ The investor is entitled to the opportunity to earn a fair return on the invested capital.¹⁵ When utility property is sold, no impediment, Constitutional or otherwise, prevents recognizing a ratemaking principle enabling ratepayers to benefit from the appreciation in value accruing while the property was in service.¹⁶ The investor does not have an absolute right to the appreciation (gain).¹⁷

15 Nonetheless, gain is not automatically allocated to ratepayers. Rather, the allocation is made based on who bore the risk of loss and the burden of the asset.¹⁸ An investor who has shielded himself against the risk of loss or has already been rewarded for taking the risk does not have a strong claim to the gain on sale.¹⁹ The burden may be measured by different methods, such as using the utility's capital

¹⁴ *Democratic Central Committee v. Washington Metropolitan Area Transit Commission*, 485 F.2d 786, 801 (1973), *reh den, cert den*, 415 US 935 (1973).

¹⁵ *Id.*

¹⁶ *Id.* at 800.

¹⁷ *Id.* at 802.

¹⁸ *See Id.* at 805-807.

¹⁹ *Id.* at 806.

structure or the percentage of the asset's cost borne by the ratepayers and shareholders. Determining the appropriate method depends largely on the facts of a specific transaction.²⁰

16 In addition, ratepayers are not required to pay imprudent or unreasonable expenses. Rather, expenses inappropriate for ratepayers to bear are excluded from rates, even though the utility incurs them. Ultimately, the utility's shareholders shoulder the burden and pay the inappropriate expenses.

17 A decision is not judged imprudent based on hindsight.²¹ Expenses resulting from a decision that was prudent and reasonable when made will likely not be excluded if ratepayers receive a benefit.²² Expenses resulting from decisions made with knowledge, or constructive knowledge, that the decision would not be in the company's or customer's best interest should be excluded.

18 In this case, Staff applied traditional regulatory theory to develop its case. Staff has met its burden by establishing AWR's rates are excessive.²³

19 **Penalty Assessment.** Staff has the initial burden of proving violations of statute, order, rule, regulation, or Commission decision occurred. This burden has

²⁰ See *In re the Matter of the Application of Avista Corporation, et al.*, Docket Nos. UE-991255, UE-991262, UE-991409 (Consolidated), Second Supplemental Order, Order Approving Sale With Conditions at ¶ 1 (March 6, 2000) (Centralia Case).

²¹ See *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309, 109 S. Ct. 609, 102 L.Ed.2d 646 (1989).

²² *Id.*; *US WEST v. WUTC*, 134 Wn.2d 74, 126, 949 P.2d 1337 (1997).

²³ Staff, Ex. 206, Response to Bench Request No. 6.

been met because Mr. Fox acknowledges the violations occurred.²⁴ The party requesting mitigation, Mr. Fox in this case, carries the burden of proving mitigating factors justify reducing or eliminating the penalty. Mr. Fox has not met his burden. Thus, the penalty should be upheld.

III. RATE CASE ISSUES

20 Regarding rate case issues, this brief first addresses Docket 010961 Account issues. Second, this brief discusses expenses. Third, this brief discusses rate base. Fourth, this brief discusses revenue. Fifth, this brief discusses capital structure and rate of return. Sixth, this brief discusses customer count and rate design.

A. **Docket 010961 Account**

21 In Docket No. UW-010961, AWR requested rates to fund two additional employees it said it needed to operate. The Commission adopted a settlement agreement between Staff and AWR and ordered a rate increase of \$3.47 in its Order Accepting Settlement Agreement. The Commission required AWR to set aside \$4.40 in a separate account to ensure the funds would be used for the intended purpose, which resulted in a \$0.93 rate decrease for AWR's then-current operations. The \$4.40 set aside amount did not belong to AWR for general use, but was earmarked for a specific purpose and restricted by special obligations.²⁵

²⁴ *Penalty Assessment Against Virgil R. Fox, President, American Water Resources, Inc.*, Docket No. UW-031596, Application for Mitigation of Penalties at ¶ 1 (November 6, 2003); Fox, Ex. 120-T at 46:9-11.

²⁵ Ward, Ex. 45, *WUTC v. AWR*, Docket No. UW-010961, Order Approving Settlement Agreement.

22 Requiring AWR to spend the money on employee expenses for the two
additional employees created a regulatory liability. Because AWR has not spent the
money on the intended purpose, the regulatory liability has not been fulfilled.²⁶

23 The Order Approving Settlement Agreement was entered on December 18,
2001. Contemporaneously, Mr. Fox was negotiating to sell AWR's largest, most
profitable water system, View Royal. Negotiations for the sale began in October or
November of 2001.²⁷ The sales agreement was executed on January 16, 2002, less
than one month after the Order was entered, and the sale closed on February 26,
2002.²⁸

24 AWR no longer needed two additional employees due to the sale.²⁹ Because
AWR would not hire the additional employees, it would not qualify to use the
funds from the Docket 010961 Account. Even so, Mr. Fox allowed AWR to continue
collecting the \$4.40 set aside amount from each of its customers for approximately
21 months after it became apparent the additional employees were not needed.

25 As a result, money accumulated in the Docket 010961 Account.³⁰ The total
amount that should be in the Account is \$125,113.³¹ Currently, the Account has a

²⁶ Ward, Ex. 40T at 35:17-20.

²⁷ Negotiations began three to four months before the sale closed in February 2002. Fox, Tr. 282:4-5 and 282:15-19.

²⁸ Ward, Ex. 53; Ex. 56 at 1.

²⁹ Ward, Ex. 46 at 1; Fox, Ex. 120T at 25:4-5; Parker, Ex. 100T at 32:1-2 and 29:8-15.

³⁰ The money was mismanaged, resulting in violations and penalties assessed on Mr. Fox. The violations are discussed in section IV. of this brief. *See Penalty Assessment Against Virgil R. Fox, President, American Water Resources, Inc.*, Docket No. UW-031596, Penalty Assessment Order.

cash balance of \$51,762. AWR improperly spent \$68,061 and collected \$5,290 from customers it never deposited. Because AWR will not use the funds for the purpose intended, the Commission must decide how AWR will fulfill its regulatory liability. This decision includes prospectively directing the money's use.

26 AWR argues it should be allowed to use the Docket 010961 Account funds to pay accounts payable and income tax resulting from the funds accumulating in the Account.³² Staff opposes this approach because the funds were granted for a specific purpose (employee expenses) and had very specific restrictions to prevent AWR from using the funds for something other than employee expenses.

27 Allowing AWR to use Docket 010961 Account funds to pay accounts payable would allow AWR to use the funds for unrestricted, general use even though the funds were restricted. Allowing AWR to use the funds to pay income tax liabilities is also inappropriate because the funds were never intended to pay tax.

28 Moreover, AWR likely does not owe tax on the accumulation of funds. Income tax is applied to income. Gross income is broadly defined as "all income from whatever source derived."³³ Income received under a claim of right is taxable in the year received.³⁴ A claim of right exists when property or funds are received

³¹ Ward, Ex. 41T at 48:16 to 49:8.

³² Parker, Ex. 100T at 35:3-7.

³³ *Florida Progress Corp. & Subsidiaries v. Commissioner of Internal Revenue*, 114 T.C. 587 at page 7 (2000). A copy of *Florida Progress* is attached to this brief as Attachment 2. Page citations are not available, but Westlaw provides page numbers on the upper right hand corner of the printed page.

³⁴ *Id.*

and treated by the taxpayer as belonging to the taxpayer.³⁵ A claim of right does not exist if there is a substantial restriction on its disposition or use.³⁶

29 When a regulatory commission exercises the authority to direct the use of funds, the regulated company does not have unfettered command over the funds.³⁷ In *Mutual Tel.*, the regulatory commission allowed the utility to collect increased rates to respond to unusually high demand for the utility's service.³⁸ The commission imposed limitations on the use and custody of the increased rates.³⁹ Although the money was intermingled with general funds, the utility had on hand sufficient money to comply with any order regarding the money's use.⁴⁰

30 The commission in *Mutual Tel.* denied the request to treat the increased rates as income because such treatment was inappropriate given the purpose for which the money was collected from ratepayers.⁴¹ The court agreed, ruling the money was not taxable until the commission ordered the disposition of funds.⁴²

31 The Commission in this case restricted the use and handling of the Docket 010961 Account funds. Thus, AWR did not have a claim of right to the money. Just as the money in *Mutual Tel.* was not taxable until disposition was ordered, the

³⁵ *Id.*

³⁶ *Id.* Also, no claim of right exists if the taxpayer must refund the amounts received.

³⁷ *Mutual Tel. Co. v. United States*, 204 F.2d 160, 161 (1953). A copy of *Mutual Tel.* is attached to this brief as Attachment 3.

³⁸ *Id.* at 160.

³⁹ *Id.*

⁴⁰ *Id.* at 161.

⁴¹ *Id.* at 161.

⁴² *Id.* at 161-162.

Docket 010961 Account funds are not taxable in this case until AWR uses the funds for a commission-sanctioned purpose. Because AWR prematurely paid tax on the funds, it can request a refund.

32 Even if AWR owes tax on the Docket 010961 Account, the tax is a direct result of Mr. Fox's imprudent decisions rendering AWR unable to use the funds for the purpose intended. Ratepayers should not have to pay for imprudent decisions.

33 On a going-forward basis, the Commission should order AWR to use the funds for employee expenses because they were originally intended for employee expenses. The Order Approving Settlement Agreement provided ample notice to AWR that it would not have unrestricted use of the money. Customers expected to fund employee expenses with the \$4.40 set aside amount. Thus, applying the Docket 010961 Account funds to employee expenses now will be consistent with the spirit of the Order Approving Settlement Agreement and legitimate customer expectations. In addition, when AWR uses the funds for employees expenses, it will have a tax deduction.⁴³

34 To offset AWR's current employee expenses with the Docket 010961 Account funds, the funds should be amortized over two years. Two years is the appropriate time frame because AWR collected the funds over approximately two years. AWR benefits from Staff's recommendation because it will be able to use the Docket

⁴³ Parker, Tr. 213:24 to 214:3.

010961 Account funds. The funds will no longer sit idle in the Account. In addition, AWR's customers benefit because the funds will be used for the purpose originally intended.

35 Staff offers a series of adjustments through which proper treatment is achieved. Because Staff amortizes the regulatory liability over two years, Pro Forma Adjustment P-5 offsets AWR's employee expenses by \$62,557, which is one half of the regulatory liability.⁴⁴ Restating Adjustment R-6 reduces AWR's rate base by the regulatory liability amount, \$125,113.⁴⁵ To recognize the two-year amortization, Rate Base Adjustment RB5 increases rate base by \$62,557.⁴⁶ Staff also reduced AWR's equity by \$125,113 to properly reflect the regulatory liability.⁴⁷

36 Staff recommends the Commission require AWR to make the appropriate accounting adjustments to its books if the Commission accepts Staff's recommendations regarding the Docket 010961 Account funds.⁴⁸

37 AWR argues that Staff's recommendation penalizes the Company and that the recommendation will create a cash flow deficit because some of the money has already been spent for other purposes. To the contrary, AWR is not unduly penalized by Staff's recommendation. AWR originally requested the funds to pay employee expenses for un-hired additional employees. AWR currently has

⁴⁴ Staff, Ex. 206, Revised response to Bench Request No. 1 at column I, row 31.

⁴⁵ Staff, Ex. 206, Revised response to Bench Request No. 1 at column E, row 54.

⁴⁶ Staff, Ex. 206, Revised response to Bench Request No. 1 at column H, row 54.

⁴⁷ Ward, Ex. 41T at 51:10-13.

⁴⁸ Ward, Ex. 40T at 39:1-3.

employee expenses for which the funds may be used. The money will be used for the proper Company purpose, not the purposes for which AWR would like.

38 Money is missing from the Account because AWR improperly spent \$68,061 and never deposited (but collected from customers) \$5,290. Even if using the missing amounts to offset AWR's employee expenses creates a cash flow deficit, the burden of that deficit belongs to the shareholder, not the ratepayers.

39 However, AWR will likely not suffer a cash flow deficit. AWR will receive a return on rate base. Staff proposes rates allowing a 10.11 percent return on rate base, which results in \$40,613 annually.⁴⁹ AWR will also receive depreciation of its rate base. Depreciation and amortization in this case results in \$54,817 annually.⁵⁰

40 The return and depreciation are essentially investor money. In this case, the return and depreciation total \$95,430. AWR can either reinvest the return in itself or pay the return to Mr. Fox. The return is typically used to pay debt expenses, and AWR has only a modest debt expense. The remainder of the return and depreciation can be used to offset the missing Docket 010961 Account funds. The

⁴⁹ To calculate the annual return, multiply Staff's proposed net rate base of \$401,714 by 10.11%. The numbers provided here reflect the new information on Mr. Fox's investment in the Birchfield water system.

⁵⁰ Brief Attachment 1, column R, row 36.

amortized amount of the missing funds is \$36,675.⁵¹ Staff's recommendation is reasonable in light of the facts in this case.

B. Expenses

41 The major expenses issues involve Pro Forma Adjustment P-5, which uses Docket 010961 Account funds to offset payroll expenses (discussed above in section III.A.); Pro Forma Adjustment P-3, employee salaries and payroll expenses; and Pro Forma Adjustment P-6, manager salary. The parties also disagree about Pro Forma Adjustment P-8, site assessment compensation; Pro Forma Adjustment P-9, rate case expenses; and Pro Forma Adjustment P-10, employee cost of living allowances (cola). Staff's adjustments result in expenses of \$461,153 for ratemaking purposes.⁵²

1. Pro Forma Adjustment P-3, Employee salaries and payroll expenses.

42 AWR argues it needs rates for employees currently employed, plus one additional field employee.⁵³ Staff opposes AWR's request and recommends the Commission set rates based on historical cost.⁵⁴

43 How much AWR should receive in rates for employee expenses is a regularly occurring theme in AWR's rate cases. In the last three rate cases, the

⁵¹ The missing funds total is \$73,351, which is the sum of funds improperly spent (\$68,061) and funds never deposited (\$5,290). Amortizing over two years results in an amortization amount of \$36,675 annually.

⁵² Brief Attachment 1, column I, row 42.

⁵³ Parker, Ex. 100T at 13:8-10 and 31:22 to 32:2; Tr. 189:11-20.

⁵⁴ Ward, Ex. 41T at 5:1-7.

Commission has allowed pro forma expenses for more employees than AWR actually employed during the test period.⁵⁵

44 In the first case, Docket Nos. UW-980072, UW-980258, UW-980265 (Consolidated) (Consolidated 1998 Dockets), AWR sought rates for two additional employees.⁵⁶ The Commission approved AWR's proposal.⁵⁷ In the second case, Docket No. UW-991392, AWR again requested rates for two additional employees, and AWR received the amounts sought.⁵⁸ In the last case, Docket No. UW-010961, AWR made its third request for rates supporting two additional employees; although the Commission granted the request, it imposed conditions to ensure the money would be used for the additional employee expenses.⁵⁹

45 After each rate case, AWR failed to hire or maintain the employees it said it needed, but customers continued to pay rates that included the costs of the additional employees.⁶⁰ For this reason, Staff recommends the Commission deny AWR's fourth request for rates to hire additional employees.

⁵⁵ Ward, Ex. 41T at 7:3-15.

⁵⁶ Ward, Ex. 41T at 7:7-13; *WUTC v. AWR*, Consolidated 1998 Dockets, Fifth Supplemental Order: Initial Order Rejecting Tariff Filing, Authorizing and Requiring Refiling at 28 (November 24, 1998) (Initial Order); *adopted* Sixth Supplemental Order (January 21, 1999).

⁵⁷ *Id.*

⁵⁸ Ward, Ex. 41T at 7:14 to 8:2; Ex. 45, *WUTC v. AWR*, Docket No. UW-991392, Order Approving Tariff Revisions (November 15, 1999).

⁵⁹ Ward, Ex. 41T at 8:3-15; *WUTC v. AWR*, Docket No. UW-010961, Order Accepting Settlement Agreement (December 18, 2001).

⁶⁰ Ward, Ex. 41T at 7:4-6.

46 In Florida, the Public Service Commission (PSC) included funds for unfilled positions in rates because the utility was actively recruiting to fill those positions.⁶¹ The utility in *Aloha* filled all but one position during the case and was actively pursuing someone for the remaining position.⁶²

47 In this case, although “an associate of one of the employees” has expressed interest, AWR is not currently recruiting to fill its open field position.⁶³ Indeed, AWR states it will not fill its open position until it receives rates supporting more employees than it currently employs.⁶⁴ Thus, while it may be appropriate for the Commission to include rates for future employees in circumstances similar to those in *Aloha*, it would not be appropriate for the Commission to do so in this case.

48 Rather, the Commission should set AWR’s rates using historical cost data, an accepted method of setting rates.⁶⁵ AWR’s employees received less than full time compensation during the test year. AWR’s test year cost for six employees, consisting of one manager, two office employees, and three field personnel, was \$23,842 in manager salary, \$89,070 in field personnel salary, \$ 56,924 in office staff salary, \$26,859 in benefits, and \$22,006 in payroll tax.⁶⁶

⁶¹ *Re Aloha Utilities, Inc.*, 217 PUR 4th 1, 33-34 (April 30, 2002). A copy of the opinion is attached to this Initial Brief as Attachment 4.

⁶² *Id.*

⁶³ Parker, Tr. 190:22 to 191:7.

⁶⁴ Parker, Ex. 100T at 13:8-10.

⁶⁵ Ward, Ex. 41T at 8:16-18; *Duquesne*, 488 U.S. at 310.

⁶⁶ Ward, Ex. 41T at 10:2 (chart).

49 AWR's history demonstrates pro forma adjustments for future employees are not successful with this Company. Amounts for additional employees are not known and measurable due to AWR's history of requesting and receiving funds to hire additional employees, then not hiring or maintaining the level of employees claimed necessary to operate. Employee expenses should be included in rates only after AWR hires and operates with the additional staff.⁶⁷

50 In the alternative, if the Commission believes an upward adjustment is warranted, Staff recommends the Commission include only the equivalent of full time compensation amounts for the six positions currently filled.⁶⁸ Full time compensation, however, may not be appropriate because AWR employees perform Satellite Management Agency (SMA) duties for United Utilities. Mr. Fox stated that the SMA duties are separate from the duties the employees perform for AWR.⁶⁹ If the Commission allows full time compensation levels, it should also require AWR to employ full time employees used only for AWR work.⁷⁰

51 This is not to say that people employed by AWR cannot also be employed by United Utilities, performing those duties with United Utilities's equipment. Instead, Staff only asserts that ratepayers should pay only for work done for AWR.

⁶⁷ Ward, Ex. 41T at 10:4-6.

⁶⁸ Ward, Ex. 41T at 5:8-12.

⁶⁹ Fox, Tr. 265:12-15.

⁷⁰ Ward, Ex. 41T at 6:14-16.

52 Full time compensation levels for AWR are \$24,000 in manager salary,
\$98,703 in field personnel salary, \$64,002 in office staff salary, \$26,859 in benefits,
and \$24,169 in payroll tax.⁷¹

2. Pro Forma Adjustment P-6, Manager salary

53 AWR proposes an adjustment to increase the manager's annual salary from
\$24,000 to \$60,000.⁷² Staff opposes the adjustment and recommends the
Commission use the previous level set in Docket No. UW-991392.⁷³

54 In Docket No. UW-991392, Staff proposed that manager compensation be
reduced to \$24,000 due to poor service quality, poor water quality, and poor
management.⁷⁴ AWR agreed to the reduced compensation level, and the
Commission accepted the agreement.⁷⁵

55 In this case, Staff recommends manager compensation remain at
approximately \$24,000⁷⁶ due to ongoing concerns about management quality.⁷⁷

Although Mr. Fox is an accomplished businessman,⁷⁸ he has had difficulty

⁷¹ Ward, Ex. 41T at 10:2 (chart).

⁷² Parker, Ex. 100T at 15:4-22.

⁷³ Ward, Ex. 41T at 11:4 to 12-17; see *In the Matter of the Application of AWR for an Order Approving Tariff Revisions*, Docket No. UW-991392, Order Approving Tariff Revisions (November 15, 1999).

⁷⁴ *In the Matter of the Application of AWR for an Order Approving Tariff Revisions*, Docket No. UW-991392, Staff Open Meeting Memo at 1 (November 15, 1999).

⁷⁵ *In the Matter of the Application of AWR for an Order Approving Tariff Revisions*, Docket No. UW-991392, Order Approving Tariff Revisions at 3-4.

⁷⁶ Staff's recommendation is to use the historical cost from the test period. See section III.B.1 above. That amount is \$23,842. However, if the Commission allows full time compensation in rates, the manager's salary would be \$24,000.

⁷⁷ Ward, Ex. 41T at 11:10-12.

⁷⁸ Fox, Ex. 120T at 11:16.

operating in the regulatory environment. This difficulty apparently stems from failed expectations due to misunderstanding regulatory principles and process.⁷⁹

56 As AWR's manager, Mr. Fox made a series of decisions adversely affecting the Company and its customers. Those decisions include unwisely selling the View Royal water system, AWR's largest, most profitable system.⁸⁰ Although Mr. Fox claims he sold View Royal because the "banks were closing in" on him,⁸¹ there is nothing in the record to support that claim or to show that AWR missed significant payments on its debt. Indeed, bank payment notices indicate AWR generally made its loan payments on time.⁸²

57 Although AWR's bank was concerned about AWR's ability to pay its debt, full payment was not demanded until May 2002, several months after the View Royal sale.⁸³ At that time, AWR had essentially drawn the maximum amount on its line of credit, some of which was used to pay off long-term debt held by Mr. Fox.⁸⁴ The bank sent AWR a letter in September 2002, stating that it expected monthly payments of at least \$10,000.⁸⁵ The letter came eight months after Mr. Fox executed the sales agreement for View Royal. Additional letters were sent in February 2003

⁷⁹ Eckhardt, Ex. 30T at 4:6-10 and 6:12-15.

⁸⁰ Ward, Ex. 41T at 11:17 to 12:1; Eckhardt, Ex. 30T at 28:13-17.

⁸¹ Fox, Ex. 120T at 39:21.

⁸² Ex. 139; Ex. 300.

⁸³ Ex. 138 at 1. Mr. Fox stated that Ms. Traxler's letter was accurate regarding the events described therein. Fox, Tr. at 274:14-22.

⁸⁴ Ex. 139 at 4.

⁸⁵ Ex. 138 at 5.

and December 2003, over a year after the sale.⁸⁶ Thus, bank pressure was likely not a reason to sell View Royal.

58 Mr. Fox sold View Royal knowing the sale would reduce AWR's revenues and the reduction would not be sufficiently offset by decreased cost. Mr. Fox also knew the average cost per customer would increase.⁸⁷ The sale reversed economies of scale and adversely affected AWR's cash flow.

59 Mr. Fox used the entire sales proceeds to reduce debt AWR owed him, personally retaining the gain rather than using it to benefit AWR and its customers. However, the proceeds were not sufficient to pay off Mr. Fox's debt. Hence, Mr. Fox decided AWR should incur additional debt by drawing on the Company's line of credit.⁸⁸ This decision was harmful to AWR and customers because it used short-term debt to pay off long-term debt, similar to using a credit card to pay a mortgage.⁸⁹

60 The View Royal sale ultimately resulted in a tax liability.⁹⁰ Ms. Parker advised Mr. Fox shortly after the sale that AWR would probably not have a tax liability. However, Ms. Parker did not calculate the gain at the time she gave her advice,⁹¹ and the tax return from the previous year, 2000, had to be redone.⁹² Thus,

⁸⁶ Ex. 138 at 6-7.

⁸⁷ Fox, Tr. 283:3-19; Parker, Tr. 211:7-9 and 17-20.

⁸⁸ Ward, Ex. 40T at 22:18 to 23:2; Ex. 56.

⁸⁹ Ward, Ex. 41T at 26:13 to 27:2.

⁹⁰ Ward, Ex. 41T at 41:12-14.

⁹¹ Parker, Tr. 207:1-4.

because there was a possibility AWR would experience a tax liability, Mr. Fox should have retained some of the proceeds instead of applying the entire amount to debt. The retained proceeds could have been used to offset the cash flow deficit the sale created, and the money would have been available to pay the tax liability once AWR amended its 2000 tax return and completed its 2001 tax return.

61 Mr. Fox's decisions also caused mismanagement of AWR's funds. For example, Mr. Fox mismanaged the Docket 010961 Account and knowingly violated the Commission's order by not depositing amounts required and spending amounts for purposes not intended.⁹³ Mr. Fox failed to hire or maintain the employees he claimed were essential to operate AWR on three occasions.⁹⁴ Mr. Fox also failed to fully use the funds in AWR's Facilities Charge and Peninsula Light Gain on Sale accounts to make capital improvements for the benefit of customers.⁹⁵

62 Using money in the Facilities Charge and Peninsula Light Gain on Sale accounts would decrease the need to use retained earnings or to incur additional debt to fund capital improvements. AWR complains that the Commission limited the 1999 surcharge to fund only 13 of the 90 needed projects⁹⁶ and that it does not

⁹² Parker, Tr.208:6 to 209:3.

⁹³ Ward, Ex. 41T at 12:6-8; *See Penalty Assessment Against Virgil R. Fox, President, American Water Resources, Inc.*, Docket No. UW-031596, Penalty Assessment Order.

⁹⁴ Eckhardt, Ex. 30T at 28:2-6; Ward, Ex. 41T at 7:4-6.

⁹⁵ Eckhardt, Ex. 30T at 28:10-13.

⁹⁶ Fox, Ex. 120T at 29:18 to 30:3.

have money for capital improvements.⁹⁷ However, it has approximately \$41,000 available to it for that purpose in the Facilities Charge account⁹⁸ and \$26,000 available in the Peninsula Light Gain on Sale account.⁹⁹ The current Facilities Charge account was established in the *Consolidated 1998 Dockets*.¹⁰⁰ Peninsula Light Gain on Sale account was established in June 2001.¹⁰¹

63 Mr. Fox implemented a policy in which he makes no significant decisions or expenditures without first consulting outside advisors.¹⁰² Mr. Fox admits this practice increases consulting fees.¹⁰³ The consulting fees increase AWR's costs and drive up rates.¹⁰⁴ Although Mr. Fox consults with people, he is AWR's sole decision-maker.¹⁰⁵

64 Mr. Fox claims he does not do things his advisors advise against.¹⁰⁶ However, although Mr. Fox's advisors told him he should not use Docket 010961 Account funds to pay taxes, he used the funds to pay income tax and capital gains

⁹⁷ Fox, Ex. 120T at 30:4-10.

⁹⁸ Ward, Ex. 83 at 6 (Item No. 136.4 Facilities Charge); Parker, Ex. 102 at 24 of 55. AWR receives \$1,860 in facilities charges from each new connection. Ward, Ex. 41T at 27:13-15. AWR also successfully petitioned to use money from this account to pay a tort settlement. Docket No. UW-040173.

⁹⁹ Ward, Ex. 83 at 6 (Item No. 138 FBC-CIAC-Cap Imp); Parker, Ex. 102 at 24 of 55.

¹⁰⁰ *WUTC v. AWR*, Consolidated 1998 Dockets, Fifth Supplemental Order at 1.

¹⁰¹ *In the Matter of the Application for the Sale and Transfer of Assets from American Water Resources, Inc., to Peninsula Light Company*, Docket No. UW-010417, Order Granting Application for Sale and Transfer of Assets and Tariff Adoption (June 27, 2001).

¹⁰² Fox, Ex. 120T at 22:13-16.

¹⁰³ Fox, Ex. 120T, 22:13-18.

¹⁰⁴ Ward, Ex. 41T at 12:9-17; Eckhardt, Ex. 30T at 28:17 to 29:1.

¹⁰⁵ Fox, Tr. 318:1-5.

¹⁰⁶ Fox, Tr. 231:3-4; Tr. 232:14-16.

tax.¹⁰⁷ He also sold View Royal after Ms. Parker advised him of the adverse effects the sale would have on AWR.¹⁰⁸ Mr. Fox continues to make decisions harmful to AWR and its customers even when his advisors advise otherwise.

65 Mr. Fox’s decisions demonstrate a pattern of continued mismanagement. Therefore, although certain service and water quality issues seem to have been positively resolved,¹⁰⁹ “customers should not have to pay higher rates for ineffective management.”¹¹⁰

66 Reducing compensation is an acceptable ratemaking principle and is not inappropriate or punitive as Mr. Fox asserts.¹¹¹ For example, in *Aloha* the Florida Public Service Commission reduced officer compensation by 50 percent for ratemaking purposes based on poor management and mismanagement of the utility.¹¹² Poor management in that case manifested itself in poor service quality.¹¹³ In this case, poor management is apparent in the harmful decisions Mr. Fox makes for AWR. Just as it was appropriate to reduce the president’s salary in *Aloha*, it is appropriate to set rates based on a reduced salary level for Mr. Fox in this case. The Commission should adopt Staff’s recommendation.

¹⁰⁷ Fox, Tr. 301:22 to 302:8.

¹⁰⁸ Parker, Tr. 211:7-9 and 17-20.

¹⁰⁹ Eckhardt, Tr. 96:6-14.

¹¹⁰ Eckhardt, Ex. 30T at 29:6-8.

¹¹¹ Fox, Ex. 120T at 13:2-4.

¹¹² *Aloha.*, 217 PUR 4th at 18-19.

¹¹³ *Id.*

3. Pro Forma Adjustment P-8, Site assessment compensation

67 AWR proposes an adjustment for site assessments of certain Group B water systems to be conducted by local health authorities pursuant to a program funded by the Department of Health (DOH).¹¹⁴ Group B water systems serve between two and 14 connections.¹¹⁵ The site assessments will involve only those Group B water systems with three to four connections.¹¹⁶

68 AWR estimates the site assessments will take approximately two hours per system and claims the site assessments will be conducted while its staff is in overtime status.¹¹⁷ AWR does not limit the number of affected systems to those with three to four connections, but rather states all of its 112 Group B systems will be visited.¹¹⁸ Staff opposes the adjustment because it is likely the site assessments will be conducted while Company staff is in regular pay status and the scope of the site assessments is much smaller than AWR represents.¹¹⁹ Because AWR will not incur additional costs from the site assessments, no adjustment is necessary.

69 The purpose of the DOH program is to inspect and collect information on Group B water systems across the state.¹²⁰ The program is not a “directive” as

¹¹⁴ Parker, Ex. 100T at 16:11 to 17:3.

¹¹⁵ Lahmann, Ex. 13 at 2.

¹¹⁶ Lahmann, Ex. 1T at 27:13-14; Ex. 13 at 8.

¹¹⁷ Parker, Ex. 100T at 16:21-23; AWR, Ex. 201, Response to Bench Request No. 2.

¹¹⁸ Parker, Ex. 111; Fox, Ex. 120T at 6:15-21; AWR, Ex. 201, Response to Bench Request No. 2.

¹¹⁹ Ward, Ex. 41T at 13:10 to 15:13.

¹²⁰ Lahmann, Ex. 1T at 26:15-16.

characterized by AWR,¹²¹ but rather is a voluntary program on the part of both the county conducting the site assessment and the water system being inspected.¹²²

70 The program is currently in its second phase. DOH published a report regarding the findings from the first phase in November 2003.¹²³ The first phase of the program focused on Group B systems with five or more connections.¹²⁴ The purpose of the second phase is to gather information on smaller Group B systems.¹²⁵

71 During the program's first phase, many of AWR's Group B systems were inspected because they had five or more connections.¹²⁶ Water systems visited in the first phase will not be visited in the second phase. For example, the Lewis County health authority will visit only one of AWR's 32 Group B water systems located in that county.¹²⁷ AWR's 112 Group B systems will not all be inspected.

72 AWR provided evidence that only one county in which it operates will inspect the Company's Group B water systems during the program's second phase. Although Pierce, Thurston, and Grays Harbor Counties are participating, those counties have not indicated they will inspect AWR's water systems. AWR may not have Group B water systems with three or four connections in those counties.

¹²¹ Parker, Ex. 100T at 16:18; Fox, 120T at 6:15-18.

¹²² Lahmann, Ex. 1T at 27:7-10. Ms. Lahmann notes that there may be negative consequences to declining. Staff is not arguing that AWR should decline to participate in the site assessments.

¹²³ Lahmann, Ex. 13.

¹²⁴ Lahmann, Ex. 13 at 2.

¹²⁵ Lahmann, Ex. 1T at 27:13-14; Ex. 13 at 8.

¹²⁶ See Ward, Ex. 66.

¹²⁷ Ward, Ex. 41T at 13:17 to 14:2; Fox, Ex. 125.

Although AWR possesses the information regarding the number of water systems with three or four connections, it did not provide that information in its analysis.¹²⁸

73 Not only is the scope of the site assessments less than AWR represents, but AWR will not incur additional employee expenses as a result of the site assessments. AWR has provided no reason why its staff cannot assist with the site assessments during regular working hours.¹²⁹ In fact, during the first phase of the DOH program, AWR staff accompanied a Lewis County health official on only one of the two days the site assessments were conducted.¹³⁰

74 Assisting with site assessments is the type of work Company staff would ordinarily perform in the normal course of their duties. AWR staff routinely visits water systems. Providing local health authority access to locked facilities is a reasonable burden because such access is necessary for the authorities to carry out their regulatory functions. In addition, it is unlikely that the local health authority will conduct the site assessments after regular business hours.

75 AWR failed to demonstrate its proposed adjustment is reasonable. No adjustment to AWR's compensation or payroll tax is necessary, and the Commission should disallow Adjustment P-8.

¹²⁸ Ms. Parker was unable to state how many of the 112 systems listed in the adjustment had three to four connections and how many had more or less than three to four connections. Ms. Parker relied on the information AWR gave her. Parker, Tr. 214:4 to 215:6.

¹²⁹ Ward, Ex. 41T at 14:14-18.

¹³⁰ Ward, Ex. 66.

4. Pro Forma Adjustment P-9, Rate case expenses

76 In its direct testimony, Staff did not propose an adjustment to rate case expenses, choosing instead to leave rate case expenses at the level previously set: \$11,000 annually.¹³¹ AWR proposes Pro Forma Adjustment P-9, which increases the amount included in rates for rate case costs. AWR originally proposed \$41,000 amortized over two years.¹³² The exhibit AWR submitted in support of Adjustment P-9 contained unsubstantiated estimates of costs.¹³³ AWR presented exhibits during Mr. Ward's cross examination suggesting costs could be as much as \$50,000.¹³⁴

77 Staff maintains that rate case cost of \$11,000 annually is appropriate. Parties appearing before the Commission are not discouraged from exercising due process rights. Thus, the Commission allows companies the opportunity to recover rate case costs to the extent fully supported by the record.¹³⁵ The Commission has rejected estimates based on speculation that a company may incur expenses related to the administrative review process.¹³⁶

78 In this case, AWR offered two declarations and an invoice to substantiate its rate case expenses containing actual numbers and estimates.¹³⁷ AWR provided

¹³¹ Ward, Ex. 41T at 16:13-17.

¹³² Parker, 100T at 17:5-11.

¹³³ Parker, Ex. 110; Ward, Ex. 41T at 15:18 to 16:1.

¹³⁴ Ward, Tr. 144:21 to 145:18; Ex. 91; Ex. 92; Ex. 96.

¹³⁵ *WUTC v. AWR*, Consolidated 1998 Dockets, Fifth Supplemental Order at 30 (adopted in Sixth Supplemental Order).

¹³⁶ *Id.* at 29-31.

¹³⁷ Ex. 91; Ex. 92; Ex. 96.

actual numbers for amounts billed. AWR provided estimates for (1) the month of April 2004 and (2) the month of May 2004 and beyond. Estimates for April 2004 are amounts accrued but not yet billed.¹³⁸ Estimates for May 2004 and beyond are poorly defined to include \$15,000 in legal fees for “writing briefs and other matters and beyond in this docket”¹³⁹ and \$2,149 in accounting fees for “work done in May and beyond in this docket.”¹⁴⁰ Although costs associated with writing post-hearing briefs may be appropriately included in rate case costs, it is impossible to separate legitimate estimates from speculative estimates.

79 Estimates AWR provided for May 2004 and beyond in this case are similar to those provided in the *Consolidated 1998 Dockets* because they contain amounts for speculative items. Estimates provided in this case are even more unreliable than those rejected in the *Consolidated 1998 Dockets* because the speculative amounts are undefined.

80 The estimates for May 2004 and beyond are also problematic because they are late-filed, unaudited, and untested. A record with wildly varying estimates and late-filed, unaudited, and untested schedules fails to “inspire confidence.”¹⁴¹

81 The Commission should reject the estimates for May 2004 and beyond.

Based on the record in this case, the Commission could determine that AWR’s rate

¹³⁸ Ex. 91; Ex. 92. Mr. Finnigan provided an estimate for part of April 2004, in addition to amounts accrued.

¹³⁹ Ex. 91 at 2.

¹⁴⁰ Ex. 92 at 2.

¹⁴¹ *WUTC v. AWR*, Consolidated 1998 Dockets, Sixth Supplemental Order at 13.

case expenses totaled \$32,884, calculated by totaling the actual billed amounts and the April 2004 estimates.¹⁴² Amortizing \$32,884 over three years results in an amortization amount of \$10,961.

82 Three-year amortization is appropriate because although AWR notes it engages in rate cases about every two years, not every filing results in litigation.¹⁴³ Indeed, Mr. Fox states he would like to establish a new, cooperative work atmosphere with Staff,¹⁴⁴ which should reduce the frequency of formal proceedings.

83 Even if AWR can substantiate legitimate rate case expenses occurring after April 2004,¹⁴⁵ \$11,000 annually remains appropriate for ratemaking purposes. The total amount of fees attributed to this consolidated docket includes fees for the penalty assessment and the Docket 010961 Account issue. Amounts related to the litigation of those items should not be included in rates and borne by the ratepayers, as explained more fully below.¹⁴⁶

84 If the Commission accepts \$50,000 as the cost of this case, that amount includes fees relating to the penalty assessment. Ratepayers should not be required to pay for fees associated with defending Mr. Fox against the penalty assessment.

¹⁴² From Ex. 91, \$7,439, \$3,658, and \$7,000. From Ex. 92, \$11,159 and \$2,692. From Ex. 96, \$936. The total of those six numbers is \$32,884.

¹⁴³ Ward, Ex. 41T at 16:4-8.

¹⁴⁴ Fox, Ex. 120T at 45:7-13.

¹⁴⁵ Staff concedes that AWR has experienced additional legal fees since the conclusion of the April 26 & 27, 2004 hearing. Both parties are submitting two rounds of post-hearing briefs, and that will result in additional legal fees.

¹⁴⁶ The Commission should consider separately whether to allow AWR to recover hearing costs for the rate case portion, the Docket 010961 Account portion, and the mitigation of penalty portion.

Instead, Mr. Fox is responsible for paying all costs associated with litigating the penalty assessment, just as he is responsible for paying any penalty the Commission ultimately orders. Based on the entire record in this proceeding, Staff estimates that 25 percent of the cost should be allocated to the penalty assessment.

85 Additionally, a portion of the fees is attributed to litigating the Docket 010961 Account issue, *i.e.*, determining how AWR will fulfill its regulatory liability. The issue is before the Commission because AWR continued collecting the set aside amount even after it became aware that it would not be able to hire the level of employees it said it needed. Collecting the set aside amount for approximately 21 months was a direct result of imprudent management decisions. Ratepayers should not incur increased rates due to poor management decisions. Thus, litigation costs associated with the Docket 010961 Account should be excluded. Based on the entire record, Staff estimates that approximately 15 percent of the costs should be allocated to the Docket 010961 Account.

86 AWR argued updates to the Company's rate case costs should be allowed. During the hearing, AWR requested the Commission take official notice of the Sixth Supplemental Order in Docket No. UW-010877 (Rainier View Order).¹⁴⁷ AWR

¹⁴⁷ AWR, Tr. 145:19 to 146:4; *WUTC v. Rainier View Water Company, Inc.*, Docket No. UW-010877, Sixth Supplemental Order, Final Order Rejecting Tariff Filing; Ordering Refiling (July 12, 2002) (Rainier View Order).

stated the Rainier View Order recognized rate case costs are hard to predict and become more accurate the further along a party is in a given case.¹⁴⁸

87 The company in *Rainier View* updated its estimate of rate case costs in its rebuttal case and post-hearing brief. The Initial Order recommended the Commission accept the updated amount.¹⁴⁹ The company also provided an additional updated estimate in its petition for administrative review.¹⁵⁰ The Commission accepted the updated estimates because Staff in that case did not persuade the Commission that its estimate was more appropriate.¹⁵¹ The Commission also noted in footnote that no procedural objections were made regarding receipt of the updated estimates.¹⁵²

88 Whereas Staff did not demonstrate that its rate case adjustment was more appropriate than the company's in *Rainier View*, Staff in this case has demonstrated that its estimate reflects AWR's actual cost associated with the rate case proceeding and the reasonable costs required. The record supports rate case costs of \$11,000 annually. Thus, the Commission should reject AWR's proposed Adjustment P-9 and adopt Staff's recommendation to leave rate case costs in rates unchanged.

¹⁴⁸ AWR, Tr. 145:22 to 146:2.

¹⁴⁹ *WUTC v. Rainier View*, Rainier View Order at ¶¶ 63-64.

¹⁵⁰ *Id.* at ¶ 70.

¹⁵¹ *Id.* at ¶¶ 69-70.

¹⁵² *Id.* at page 16, footnote 3.

5. Pro Forma Adjustment P-10, Employee COLA

89 AWR proposes Pro Forma Adjustment P-10, “added to reflect a cost of living allowance for all employees.”¹⁵³ AWR did not file Adjustment P-10 its testimony, but introduced it in response to the bench requests on April 23, 2004.¹⁵⁴

90 AWR provided no evidence that Adjustment P-10 corresponds with the rate of inflation during the test period. Although Staff agrees a COLA adjustment may be appropriate under certain circumstances,¹⁵⁵ it has not been established that those circumstances exist.¹⁵⁶ In addition, Adjustment P-10 is ambiguous. AWR’s proposed adjustment is either a one-time five percent increase or a five percent increase amortized over two years. AWR has failed to demonstrate its proposed adjustment is reasonable.

91 Because AWR has not established that Adjustment P-10 reflects an appropriate rate of inflation, because appropriate economic conditions warranting a COLA have not been established, and because the adjustment is ambiguous, the Commission should reject Adjustment P-10.

¹⁵³ AWR, Ex. 201, Response to Bench Request No. 3.

¹⁵⁴ Because this was a late-offered adjustment, no discovery was conducted on Adjustment P-10.

¹⁵⁵ Ward, Tr. 139:19-22.

¹⁵⁶ Ward, Tr. 140:1-10.

6. Uncontested Expense Adjustments

92 Staff and AWR agree with regard to the following adjustments: Restating Adjustment R-2, which removes IRS penalties totaling \$2,597;¹⁵⁷ Restating Adjustment R-4, which removes non-recurring legal expenses totaling \$2,902;¹⁵⁸ Restating Adjustment R-5, which removes out-of-period tax expenses totaling \$37,364;¹⁵⁹ and Pro Formal Adjustment P-7, which adds Pierce County permitting costs totaling \$2,090.¹⁶⁰ Staff and AWR agree in principle regarding Restating Adjustment R-3, which removes certain accounting expenses.¹⁶¹ Staff asserts that Adjustment R-3 should remove \$3,826 from AWR's expenses.¹⁶²

C. Rate Base

93 Staff's adjustments, as presented in exhibits and testimony, results in a rate base of \$327,584 for ratemaking purposes.¹⁶³ Testimony obtained at the hearing¹⁶⁴ caused a change to Staff's recommendation regarding gain on the sale of the Birchfield water system, which results in a rate base of \$402,395.¹⁶⁵

94 One area of major controversy concerning AWR's rate base involve the adjustments relating to the Docket 010961 Account. Those adjustments are

¹⁵⁷ Parker, Tr. 187:3-8; Ex. 100T at 10:1-9; Ward, Ex. 40T at 12:12 to 13:6.

¹⁵⁸ Parker, Tr. 188:5-7; Ex. 100T at 11:18-23; Ward, Ex. 40T at 14:13 to 15:5.

¹⁵⁹ Parker, Tr. 188:8-11; Ex. 100T at 12:1-6; Ward, Ex. 40T at 15:7-13.

¹⁶⁰ Parker, Tr. 188:12-15; Ex. 100T at 16:1-10; Ward, Ex. 41T at 13:1-8.

¹⁶¹ Parker, Tr. 187:9 to 188:1. The difference in the numbers is minimal.

¹⁶² Staff, Ex. 200 at page 4, paragraph 13.

¹⁶³ Staff, Ex. 206, Revised Response to Bench Request No. 1 at column R, row 58.

¹⁶⁴ Ward, Tr. 122:24 to 125:11; Tr. 167:2 to 173:25.

¹⁶⁵ Brief Attachment 1, column R, row 58.

Restating Adjustment R-6, which removes from rate base the amount of the regulatory liability totaling \$125,113, and Rate Base Adjustment RB5, which amortizes the regulatory liability over two years. The Docket 010961 Account adjustments are discussed above in section III.A. Significant controversy also exists regarding Rate Base Adjustment RB4, which allocates the apparent gain from the sale of the Birchfield water system, and Rate Base Adjustment RB3, which allocates gain from the sale of the View Royal water system.

1. Rate Base Adjustment RB4, Birchfield Gain on Sale

95 Staff proposes an adjustment to rate base allocating gain from the sale of the Birchfield water system. The Lewis County Utility Corporation (LCUC), owned by Mr. Fox, originally devoted Birchfield to public service in July 1996.¹⁶⁶ Mr. Fox changed LCUC to AWR,¹⁶⁷ and he received common stock and a note payable when Birchfield was incorporated into AWR.¹⁶⁸

96 In testimony, Staff states AWR sold Birchfield for \$256,500 over rate base and realized a net gain of \$218,025.¹⁶⁹ Rate base for Birchfield was \$57,700. The buyer, Lewis County Water and Sewer District No. 5, paid a total of \$325,000.¹⁷⁰ One promissory note was issued to AWR in the amount of \$57,500, and the buyer

¹⁶⁶ Ward, Ex. 40T at 25:12-13; Fox, Ex. 120T at 36:15 to 37:4.

¹⁶⁷ Fox, Ex. 120T at 37:2-4.

¹⁶⁸ Parker, Ex. 100T at 26:1-2; Tr. 204:22 to 205:6.

¹⁶⁹ Ward, Ex. 40T at 24:17 to 25:9; Ex. 41T at 35:15.

¹⁷⁰ Ward, Ex. 57.

assumed a debt obligation.¹⁷¹ Another note was issued to Mr. Fox and his wife for \$256,500.¹⁷² It appears that all three wells associated with Birchfield were being used at the time of sale to provide water service.¹⁷³

97 It appears from documents submitted by AWR to three different state agencies, the Commission, the Department of Ecology (Ecology), and DOH, that Birchfield consisted of one water system and was owned solely by AWR. If this is true, then the amount of the purchase price exceeding rate base is gain to be allocated between the shareholder and ratepayers.

98 Staff understood AWR owned Birchfield, a single water system consisting of three wells and the associated infrastructure.¹⁷⁴ Documents submitted to the Commission by AWR support Staff's belief. For example, AWR provided Staff with information on its internal tracking system in 1998.¹⁷⁵ AWR listed three wells associated with Birchfield,¹⁷⁶ indicating the wells were included in rate base. It is difficult to derive every asset owned by AWR from its depreciation schedules because some assets are combined rather than listed individually.¹⁷⁷ Data from Ecology and DOH supplies more information regarding AWR's relationship to Birchfield.

¹⁷¹ Ward, Ex. 57 at 14-15.

¹⁷² Ward, Ex. 57 at 16-17.

¹⁷³ Lahmann, Ex. 17 at 16.

¹⁷⁴ Ward, Ex. 41T at 30:18-19; Tr. at 163:20-23.

¹⁷⁵ Ward, Ex. 76 at 1.

¹⁷⁶ Ward, Ex. 76 at 1:7-9.

¹⁷⁷ Ward, Tr. at 165:23 to 166:7.

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Information provided to Ecology indicates AWR owned the entire Birchfield system. Ecology prepared a Report of Examination in consideration of Mr. Fox's 1992 application to appropriate ground water. The Report contained a description of Birchfield and the development it was designed to serve. The description indicates Mr. Fox contemplated only one integrated project involving Birchfield:

"The project site is located in Lewis County, approximately five miles east of Onalaska, Washington. Virgil Fox proposes to expand the existing Birchfield Water System to eventually serve a variety of developments throughout the 600+ acre tract....The expanded Birchfield water system will include three wells which will be interconnected to serve the development."¹⁷⁸

Although the application predates AWR's existence, it provides a clear picture of the intent behind the Birchfield water system.

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In addition, the application demonstrates that all three wells were an integral part of Mr. Fox's plan for Birchfield. When Mr. Fox transferred water rights from the three wells to LCUC,¹⁷⁹ AWR's predecessor, he established the intent to continue developing the plan through the water company. Indeed, Mr. Fox managed the water rights associated with Birchfield through AWR until Birchfield was sold to the Lewis County Water and Sewer District No. 5.¹⁸⁰

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Information from DOH also suggests AWR owned the entire Birchfield water system. DOH assigns each water system a unique identification number.

¹⁷⁸ Ward, Ex. 77 at 5.

¹⁷⁹ Ward, Ex. 77 at 10-12.

¹⁸⁰ Ward, Ex. 77 at 14-17.

Birchfield is assigned only one identification number: 003157.¹⁸¹ Each water system is required to file a Water Facilities Inventory (WFI) form with DOH.¹⁸² The initial WFI for Birchfield shows Mr. Fox as the owner, and the water system had only one well.¹⁸³ An updated WFI submitted in September 2002, lists AWR as Birchfield's owner, and the water system consisted of three wells.¹⁸⁴

102 AWR submitted a construction plan for expansion of Birchfield.¹⁸⁵ Mr. Fox claims he personally requested the expansion,¹⁸⁶ however, the construction plan states:

This Project Report is developed at the request of American Water Resources, Inc., for the purposes of obtaining approval for additional connections based on the existing facilities installed during the initial development of the Birchfield Water System....¹⁸⁷

103 The construction plan indicates that AWR owned Birchfield, and lists Mr. Fox as president and CEO of AWR. The construction plan does not indicate that Mr. Fox owned part of Birchfield outside of AWR.¹⁸⁸

104 It was not until the September 5, 2003 sales agreement that Mr. Fox claimed he owned part of Birchfield separately from AWR.¹⁸⁹ Mr. Fox admits the sales

¹⁸¹ Lahmann, Ex. 1T at 30:3-6.

¹⁸² Lahmann, Ex. 1T at 30:2-3.

¹⁸³ Lahmann, Ex. 1T at 30:6-8; Ex. 14.

¹⁸⁴ Lahmann, Ex. 1T at 30:12-14; Ex. 15.

¹⁸⁵ Lahmann, Ex. 1T at 31:4-5; Ex. 17.

¹⁸⁶ Fox, Ex. 120T at 37:14 to 38:1.

¹⁸⁷ Lahmann, Ex. 17 at 7.

¹⁸⁸ Lahmann, Ex. 17 at 8.

¹⁸⁹ Ward, Ex. 57.

agreement is not accurate in its recitation of assets: the agreement lists water rights as belonging to Mr. Fox individually, when they belonged to AWR.¹⁹⁰

105 Mr. Fox states he invested money into the Birchfield water system.¹⁹¹ Interestingly, Mr. Fox testifies his understanding was that he could not own regulated and non-regulated water systems.¹⁹² Yet, this is precisely what Mr. Fox claims he did with Birchfield.

106 Through records provided by AWR, Staff confirmed some investment was made.¹⁹³ By making the investment, Mr. Fox did not separately own a portion of Birchfield, but rather made a capital investment in AWR. Staff confirmed that Mr. Fox invested \$78,428 in Birchfield.¹⁹⁴ This amount does not include labor costs, but only material costs. Although there would also be labor expenses,¹⁹⁵ Staff was not able to determine the reasonable amount of those expenses because AWR's data did not allow that analysis.¹⁹⁶

¹⁹⁰ Fox, Tr. 291:1-11; Ward, Ex. 77 at 10-12.

¹⁹¹ Fox, Ex. 120T at 37:14-23.

¹⁹² Fox, Ex. 120T at 36:21-23.

¹⁹³ Ward, Ex. 142; Ex. 143.

¹⁹⁴ Ward, Ex. 143; Tr. 167:2 to 173:25.

¹⁹⁵ Ward, Tr. 125:9-11.

¹⁹⁶ Ward, Tr. 177:12 to 178:19.

107 Based on the investment, gain from the Birchfield sale is \$139,597.¹⁹⁷ The
gain is calculated by subtracting from \$256,500 (the amount over rate base) the tax
and escrow costs totaling \$38,475 and the additional investment totaling \$78,428.

108 The gain should be allocated between the shareholder and ratepayers
according to a four-year averaging of AWR's capital structure, the method used to
allocate the gain AWR experienced from the sale to Peninsula Light.¹⁹⁸ The four-
year averaging of AWR's capital structure results in 94.5 percent debt and 5.5
percent equity. The amount allocated to ratepayers should correspond with debt
and totals \$131,945. The amount allocated to the shareholder should correspond
with equity and totals \$7,651. To effect the allocation to ratepayers, Staff
recommends the Commission reclassify \$131,945 of equity to CIAC.¹⁹⁹

2. Rate Base Adjustment RB3, View Royal Gain on Sale

109 Staff proposes an adjustment allocating gain from the sale of the View Royal
water system between the shareholder and ratepayers. AWR sold View Royal for
\$500,000, which exceeds rate base by \$335,550.²⁰⁰ The net gain on sale is \$287,265.²⁰¹

¹⁹⁷ An updated calculation of the gain from the sale of Birchfield is attached to this brief as Attachment 5.

¹⁹⁸ *In the Matter of the Application for the Sale and Transfer of Assets from AWR to Peninsula Light Company*, Docket UW-010417, Order Granting Application for Sale and Transfer of Assets and Tariff Adoption; Ward, 41T at 27:7-9. Although the Commission's order in *Peninsula Light* does not explain how the allocation was made, Mr. Ward testifies that the four-year averaging of AWR's capital structure was used in that case.

¹⁹⁹ See Ward, Ex. 41T at 35:15-19.

²⁰⁰ Ward, Ex. 53 at 3; Ex. 41T at 24:18.

²⁰¹ Ward, Ex. 41T at 30:7. Staff's testimony reflects two numbers for gain on the View Royal sale. Ward, Ex. 41T at 28:19 states the gain was \$221,009. That number is incorrect because it does not

110 Allocating gain in this case is appropriate because both the shareholder and ratepayers shared in the purchase cost and the cost of improvements.²⁰² When AWR purchased it, View Royal's rate base was \$10,192.²⁰³ While View Royal was devoted to public service, its rate base increased to reflect items such as maintenance and capital upgrades.²⁰⁴ At the time of sale, View Royal's rate base was \$164,450.²⁰⁵ Because the shareholder and ratepayers shared the burden of View Royal, they should also share the benefit.

111 This Commission, and other jurisdictions, recognize that sharing gain from the sale of assets is an acceptable ratemaking principle.²⁰⁶ The Commission recognizes case-specific circumstances may warrant reasonable allocation of gain between shareholders and ratepayers.²⁰⁷ Gain should be allocated in light of both regulatory principles and other risks and benefits of the transaction.²⁰⁸ In *Centralia Case*, the Commission relied on the broad principle that reward should follow risk

incorporate Staff's recommendation regarding the acquisition adjustment. Gain of \$287,265 reflects the acquisition adjustment.

²⁰² Ward, Ex. 41T at 28:7-14.

²⁰³ Ward, Ex. 41T at 28:11-12.

²⁰⁴ Ward, Ex. 40T at 22:1-4.

²⁰⁵ Ward, Ex. 41T at 28:13.

²⁰⁶ See Ward, Ex. 69.

²⁰⁷ *Centralia Case*, Docket Nos. UE-991255, UE-991262, UE-991409 (Consolidated), Second Supplemental Order at ¶ 1.

²⁰⁸ *Id.* at ¶ 64.

and benefit should follow burden.²⁰⁹ This broad principle was developed in *Democratic Central*, *supra* note 14, and its progeny.²¹⁰

112 The principle that reward should follow risk and benefit should follow burden should be applied in this case, and the Commission should allocate the gain according to AWR's capital structure. The allocation should be made using a four-year averaging of AWR's capital structure.²¹¹ This is the same method Staff and AWR used to allocate gain resulting from the sale to Peninsula Light.²¹²

113 Using AWR's capital structure to allocate gain is appropriate because it is representative of the burden carried by the shareholder and ratepayers. In this case, the four-year average of AWR's capital structure results in 97.9 percent debt and 2.1 percent equity.²¹³ The amount of gain allocated to ratepayers should correspond with debt and totals \$281,232. The amount allocated to the shareholder should correspond with equity and totals \$6,033.

114 In the alternative, if the Commission chooses not to use capital structure to allocate gain, Staff recommends the Commission use an analysis of the symmetry of risk. Symmetry of risk allocates the benefits and burdens of the transaction based

²⁰⁹ *Id.* at ¶ 84.

²¹⁰ *Id.* at ¶¶ 78-80.

²¹¹ Ward, 41T at 27:7-9.

²¹² *In the Matter of the Application for the Sale and Transfer of Assets from AWR to Peninsula Light Company*, Docket UW-010417, Order Granting Application for Sale and Transfer of Assets and Tariff Adoption; Ward, 41T at 27:7-9.

²¹³ Ward, Ex. 71.

on the proportion of cost for which the shareholder and ratepayers were responsible.²¹⁴ This method is also consistent with *Democratic Central*.

115 Under symmetry of risk, the ratepayers' burden equals the amount included in rate base. The shareholder's burden equals the amount excluded from rate base. In this case, the amount of rate base associated with View Royal was \$164,450.²¹⁵ At the time of the sale, the cost of View Royal not included in rate base was \$164,808.²¹⁶ Thus, the total cost for View Royal was \$329,258; the ratepayers carried 49.95 percent of the cost burden, and the shareholder carried 50.05 percent.²¹⁷

116 The Commission's decision regarding the allocation of gain affects AWR's acquisition adjustment, which is Restating Adjustment R-11 (discussed below). View Royal was purchased at a premium. AWR's shareholder should be rewarded through either the acquisition adjustment or gain on sale, but not both.

117 If the Commission accepts Staff's primary recommendation to allocate gain using capital structure, AWR should be allowed the acquisition adjustment. Under Staff's primary recommendation, the shareholder will receive the benefit from the balancing achieved through the acquisition adjustment, but not from gain on sale.

118 However, if the Commission adopts Staff's alternative recommendation, the acquisition adjustment should be rejected. Under the symmetry of risk analysis, the

²¹⁴ Ward, Ex. 41T at 29:9-12.

²¹⁵ Ward, Ex. 41T at 29:16-19 and 30:2-3.

²¹⁶ Ward, Ex. 41T at 29:13-15 and 30:1-2.

²¹⁷ Ward, Ex. 41T at 30:4-5.

shareholder receives the benefit from gain on sale, thus no balancing through the acquisition adjustment is needed. The balancing process is discussed further below.

3. Restating Adjustment R-11, Acquisition Adjustment

119 Staff and AWR agree an acquisition adjustment may be appropriate in this case.²¹⁸ Staff conditions its agreement on the Commission allocating gain on the View Royal sale using AWR's capital structure.²¹⁹ The acquisition adjustment, Adjustment R-11, adds back to rate base the amount of AWR's acquisition adjustment account. AWR's acquisition adjustment account is listed on the Company's balance sheet as 114.1 – Acquisition Adjustment.²²⁰ The amount in that account is (\$193,834). The amortization of the acquisition adjustment account was \$19,407, which results in a net acquisition adjustment amount of (\$174,427).²²¹

120 If no adjustment were made, AWR's rate base would be reduced by the net acquisition adjustment account amount, (\$174,472). Adjustment R-11 prevents this by adding a positive \$174,427, causing the effect on rate base to be zero.²²²

121 Adjustment R-11 relates to an issue originating in the *Consolidated 1998 Dockets*.²²³ In the *Consolidated 1998 Dockets*, AWR proposed to add to rate base an amount reflecting premiums paid for two water systems, View Royal and H2O

²¹⁸ Ward, Ex. 41T at 18:13-16.

²¹⁹ Ward, Ex. 41T at 21:15-17.

²²⁰ Ward, Ex. 43 at 1; Parker, Ex. 102 at 24 of 55.

²²¹ *Id.*

²²² Staff, Ex. 206 at ¶¶ 4-5 and Attachment A (Staff's Response to Bench Request No. 1 (Revised)).

²²³ Ward, Ex. 41T at 18:16-18; *WUTC v. AWR*, Consolidated 1998 Dockets, Fifth Supplemental Order at 10-18.

Water Systems.²²⁴ The Commission disagreed and allowed only the historical cost of the acquired water systems to be included in rate base.²²⁵ This resulted in a balancing of premium purchases and discount purchases.

122 When a utility makes a premium purchase, the amount paid over rate base is not automatically allowed in rates. Rather, the utility must demonstrate a benefit to customers commensurate with the amount over rate base before it is allowed.²²⁶

123 Balancing premium and discount purchases gives utilities flexibility to purchase troubled utilities that can only be purchased at a premium.²²⁷ The balancing is accomplished by allowing the utility to include the higher historical cost of discount purchases in rate base, offsetting disallowed premium amounts. Allowing a utility to receive a return on the higher historical cost for discount water systems rewards the utility for purchasing the distressed systems.²²⁸ This rewards the utility for taking the risk of purchasing the distressed systems, and also reduces the utility's claim on any gain on sale.²²⁹

124 This is not to say that a utility is automatically entitled to the higher historical cost for discount systems. Indeed, AWR acknowledges it does not have

²²⁴ *WUTC v. AWR*, Consolidated 1998 Dockets, Fifth Supplemental Order at 10.

²²⁵ *Id.*

²²⁶ *Id.* at 12.

²²⁷ *Id.* at 11-12.

²²⁸ *Id.*

²²⁹ *See Democratic Central*, 485 F.2d at 806.

an absolute right to recover historical cost.²³⁰ Rather, the Commission considers the facts of a particular case to determine whether an acquisition adjustment will be allowed.²³¹

125 In this case, balancing is only appropriate if gain from the View Royal sale is allocated between ratepayers and the shareholder according to AWR's capital structure.²³² If the Commission does not allocate gain using capital structure, no balancing is needed. The shareholder will be fully rewarded for purchasing distressed systems because he will receive the premium amount through the gain.²³³ Thus, the Commission should allow Adjustment R-11 only if it allocates gain from the View Royal sale according to Staff's primary recommendation.

4. Non-controversial Rate Base Adjustments

126 Staff and AWR agree with regard to Rate Base Adjustment RB2, labeled by the Company as Restating Adjustment R-10, which adjusts rate base to reflect the remaining surcharge amount.²³⁴ The amount of the adjustment is \$267,661. Staff and AWR also agree concerning Restating Adjustment R-7, which adds to rate base the unamortized balance of AWR's miscellaneous deferred debit account in the amount of \$6,467;²³⁵ Restating Adjustment R-8, which adds to rate base the average

²³⁰ Parker, Tr. 202:24 to 203:15.

²³¹ *WUTC v. AWR*, Consolidated 1998 Dockets, Sixth Supplemental Order at 12.

²³² Ward, Ex. 41T at 21:13-17.

²³³ Ward, Ex. 41T at 21:18 to 22:2.

²³⁴ Parker, Tr. 202:6-23; Ex. 100T at 20:12 to 21:6; Ward, Ex. 40T at 17:9 to 19:15.

²³⁵ Parker, Tr. 201:6-9; Ex. 100T at 18:9-15; Ward, Ex. 41T at 17:5-10.

balance of AWR's dedicated checking account in the amount of \$36,366;²³⁶ and Restating Adjustment R-9, which reduces rate base by the net Contribution in Aid of Construction and accumulated amortization amounts associated with the reserve account created in Docket No. UW-010417.²³⁷ The amount of Adjustment R-9 is \$59,515.

127 AWR and Staff agree rate base should be calculated by using a beginning of year / end of year average (BEOY).²³⁸ It appears that Staff and AWR began with slightly different numbers to calculate the BEOY average. Staff used numbers provided by AWR, contained in Staff's Exhibit No. 43 (Ward). In particular, Staff used the numbers found on pages 10 and 11 of Exhibit No. 43. AWR used the numbers contained in its Exhibit No. 102 (Parker) at pages 25 of 55 through 26 of 55.

128 Exhibit No. 102 appears to have been created on February 4, 2004. The data provided to Staff appears to have been prepared on November 19, 2003. The difference between Exhibit No. 43 and Exhibit No. 102 is in the Contribution in Aid of Construction in the Facilities Charge Account (Number 271.1) and the Service Connections Account (Number 271.3). It appears that Exhibit 102 contains amounts for one less customer.

²³⁶ Parker, Tr. 201:20-25; Ex. 100T at 18:16 to 19:7; Ward, 41T at 17:12-16.

²³⁷ Parker, Tr. 202:1-5; Ex. 100T at 19:8 to 20:11; Ward, Ex. 41T at 17:18 to 18:11.

²³⁸ Ward, 40T at 17:1-7; Parker, 100T at 17:19-21.

129

Comparing AWR's and Staff's results of operations exhibits demonstrates agreement between the parties.²³⁹ The number on AWR's results of operations is \$920,616,²⁴⁰ which is not a per books number, but rather rate base already adjusted for the BEOY average. Staff's rate base as adjusted for the BEOY average is \$852,074.²⁴¹ The difference is essentially the treatment of the regulatory liability: Staff reduced rate base, and AWR did not.

D. Revenue

130

The parties propose three uncontested adjustments to AWR's revenue. The first adjustment is Restating Adjustment R-1, which removes income from AWR's SMA operations totaling \$11,108.²⁴² The second adjustment is Pro Forma Adjustment P-1, which removes an overstatement of \$1,104 from AWR's accounts receivable.²⁴³ The third adjustment is Pro Forma Adjustment P-2, which removes the \$4.40 set aside amount totaling \$79,306.²⁴⁴

²³⁹ Ward, Ex. 42 at column I, row 58; AWR, Ex. 201 at page 10 (labeled Exhibit No. ____ (JMP-2), page 1 of 2, American Resources, Inc., Pro Forma Results of Operations, 12 Months ended June 30, 2003) at column D, row 55.

²⁴⁰ AWR, Ex. 201, page 10, column D, row 55.

²⁴¹ Ward, Ex. 42 at column I, row 58.

²⁴² Parker, Tr. 186:17-20; Ex. 100T at 8:1-8; Ward, Ex. 40T at 8:13-19.

²⁴³ Parker, Tr. 186:21 to 187:1; Ex. 100T at 8:9-17; Ward, Ex. 41T at 3:8-14.

²⁴⁴ Parker, 100T at 8:18 to 9:3; Ward, Ex. 41T at 3:16 to 4:3.

E. Capital Structure, Return on Debt, Return on Equity, Rate of Return

131 AWR's current capital structure is 35 percent debt and 65 percent equity.²⁴⁵
Staff's recommendation for the Docket 010961 Account reduces equity by \$125,113,
resulting in a capital structure of 42.2 percent debt and 57.8 percent equity.²⁴⁶

132 The amount of AWR's debt is \$273,477.²⁴⁷ AWR's weighted cost of debt is
7.53 percent.²⁴⁸ The amount of AWR's equity, taking into account Staff's
recommendation regarding the Docket 010961 Account, is \$374,557.²⁴⁹ The return
on equity is 12 percent.²⁵⁰ AWR's weighted cost of capital is 10.11 percent.²⁵¹

133 Not only does Staff's recommendation properly treat the Docket 010961
Account funds, but it is also reasonable. Capital structures rich in equity can
impose an unfair burden to the customer.²⁵²

F. Customer Count, Rate Design

134 **Customer Count.** AWR's average customer count is 1,501.²⁵³ There are two
different methods of calculating the average customer count, both related to the
calculation of BEOY. The first method is to sum the amount on the first day of the

²⁴⁵ Parker, Ex. 100T at 35:13-14.

²⁴⁶ Ward, Ex. 41T at 51:10-13.

²⁴⁷ Ward, Ex. 41T at 51:16; Ex. 84.

²⁴⁸ Ward, Ex. 41T at 51:16-17; Ex. 84; AWR, Ex. 201, Response to Bench Request No. 8.

²⁴⁹ Ward, Ex. 41T at 52:3-6.

²⁵⁰ Ward, Ex. 41T at 52:3; Ex. 84; AWR, Ex. 201, Response to Bench Request No. 8.

²⁵¹ Ward, Ex. 41T at 52:9; Ex. 84.

²⁵² See *WUTC v. US WEST*, Docket No. UT-950200, Fifteenth Supplemental Order, Commission Decision and Order Rejecting Tariff Revisions; Requiring Refiling at 74 to 76 (April 11, 1996) (capital structure of 56.6% equity and 43.4% debt was unreasonable and unwise for the company and it was so unreasonable and varied from the usual practice as to impose an unfair burden on the customer).

²⁵³ Ward, Ex. 40T at 40:3-7; Ex. 41T at 52:14.

test period and the amount on the last day of the test period, and divide by two.

This is the standard method used to calculate BEOY because companies typically do not have records to calculate BEOY using the second method, which calculates BEOY by averaging the monthly averages.

135 The monthly average is calculated by summing the amount on the first day of the month and the amount on the last day of the month, and dividing by two. The monthly averages are then summed and divided by the number of months to equal the average of the monthly averages.

136 Staff derived the average customer count by using the standard method of calculating BEOY, which is the same method Staff used to calculate the BEOY for rate base. Staff used numbers provided by AWR in submissions to the Commission pursuant to quarterly reporting requirements.

137 AWR derived its average customer count using the second method, while using the standard method to calculate BEOY for rate base.²⁵⁴ The same method used to calculate BEOY for rate base should be used to calculate the customer count. Thus, Staff's average customer count should be used to calculate AWR's rates.

138 **Rate design.** Staff proposes a rate design applying the full reduction to Flat Rate service.²⁵⁵ Metered rates are designed to produce the same average monthly

²⁵⁴ Parker, Ex. 100T at 36:14-17; Ex. 103.

²⁵⁵ Ward, Ex. 41T at 53:14.

revenue as the flat rate.²⁵⁶ Under Staff's rate design, approximately half of AWR's revenues will be from the base charge, and the remaining half will be achieved through the usage charge, which is similar to how revenue is currently distributed.

139 The numbers presented in this section reflect Staff's incorporation of the new Birchfield information discussed in section III.C.1. of this brief. Thus, the numbers will differ from those found in Mr. Ward's testimony, Exhibit No. 41T at page 54.

140 AWR's current Flat Rate service is \$33.07.²⁵⁷ The monthly average revenue resulting from Staff's adjustments is \$27.38, a difference of \$5.69.

141 AWR's current base rate for Metered Rates is \$16.77.²⁵⁸ Staff proposes the base rates be reduced to \$13.42, which is approximately 80 percent of the current amount.²⁵⁹ The difference between the current base rate and Staff's proposed base rate is \$3.35. The remaining amount of the proposed decrease would be reflected in usage rates. The Commission should set AWR's usage rates as follows:

0-500 Cuft	0.0120
>500 Cuft	0.0152

142 Staff's proposed rate design would be the same whether the rate change is an increase or a decrease. AWR proposes the entire amount of the rate change be

²⁵⁶ Ward, Ex. 41T at 53:16-17.

²⁵⁷ Ward, Ex. 41T at 54:11 (chart).

²⁵⁸ Ward, Ex. 41T at 54:11 (chart).

²⁵⁹ Ward, Ex. 41T at 54:8-9 and 54:11 (chart).

applied to the base rate for all customers.²⁶⁰ AWR argues that because the increase in the last rate case, presumably Docket No. UW-010961, was applied to the base rate, the Commission should apply the rate change to the base rate in this case.

143 In Docket No. UW-010961, the Commission granted AWR a rate increase for a specific purpose (hiring two additional employees) and created a regulatory liability by requiring the funds collected from the rate increase be placed in a separate account. Because the funds were earmarked for a specific purpose, it was important for the money be collected from the base rate. If all or a portion of the increase was allocated to usage, there would have been no certainty that AWR would receive the revenue needed to set aside the required amount. In many respects, the rate increase in Docket No. UW-010961 was similar to a surcharge.

144 This case involves an evaluation of AWR's general rates. The rates are not being implemented to achieve a specific funding purpose. Rather, the goal is to establish fair, just, reasonable, and sufficient rates. No new regulatory liabilities are being created. Thus, applying the change in rates from this proceeding to only the base rate is neither necessary nor appropriate.

145 Important policy considerations support applying a portion of the rate change to usage rates. Applying a portion of the rate change to usage rates sends price signals to AWR's customers. Water is a finite resource; and water systems

²⁶⁰ Parker, Ex. 100T at 36:19-20.

have physical limitations, both due to the water source and the facilities used to provide water service. Without price signals, customers would be encouraged to drain, rather than conserve, the resource. This would not be in the public interest. Therefore, the Commission should set AWR's rates to apply a portion of the rate change to both the base rate and the usage rate for metered customers.

IV. PENALTY ASSESSMENT

146 Mr. Fox knowingly and calculatingly violated the Commission's Order Approving Settlement Agreement by failing to fund AWR's Docket 010961 Account as required although the amounts were billed and collected, and by using the funds from the Account for unauthorized purposes.

147 Mr. Fox understood the settlement agreement and the Commission's Order Approving Settlement Agreement, which created the Docket 010961 Account and the set aside obligation.²⁶¹ Mr. Fox also recognized the importance of the Commission's Order.²⁶² Because the violations were deliberate and because Mr. Fox has not offered sufficient mitigating factors, the Commission should order the entire penalty amount, \$3,700, be paid in full by Mr. Fox personally within 15 days of entering the final order.

148 Approximately one month after the Order Approving Settlement Agreement was entered on December 18, 2001, Mr. Fox, through AWR, executed an agreement

²⁶¹ Fox, Tr. 298:16-23.

²⁶² Fox, Ex. 120T at 46:22.

to sell View Royal. Due to the sale, AWR no longer needed additional employees to provide service. Mr. Fox knew as early as January 2002, that AWR would not hire the additional employees.²⁶³ He should have known before the sale because he should have conducted a thorough analysis of how the sale would affect AWR.

149 Because AWR would not hire the additional employees, it would not qualify to use the Docket 010961 Account funds. Even so, Mr. Fox allowed AWR to collect \$125,113 its customers over approximately 21 months.

150 Funds were not deposited into the Docket 010961 Account as required in June, July, August, September, October, and November 2002. In June 2003, Mr. Fox caused AWR to withdraw \$66,258²⁶⁴ from the Docket 010961 Account for unauthorized purposes.

151 Mr. Fox offers three reasons why the penalty assessment should be mitigated. First, Mr. Fox argues his decision to violate the Commission's Order came after careful thought and obtaining advise. Second, Mr. Fox argues Staff is to blame for the violations. Third, Mr. Fox argues he had no choice but to commit the violations. None of Mr. Fox's reasons justify mitigation.

²⁶³ Fox, Tr. 284:10-16.

²⁶⁴ This number is slightly lower than the amount discussed in section II.A. of this brief because penalties were not applied to all of the expenditures.

A. Violations Resulted from a Thoughtful and Advised Decision

152 Although Mr. Fox testifies that violations occurred after consulting with his attorney and accountant,²⁶⁵ he also testified that neither of his advisors counseled him to violate Commission orders, rules, or statutes.²⁶⁶ Even if Mr. Fox's advisors counseled him to commit the violations, receiving advice to act one way or another is not a mitigating factor justifying reducing or eliminating the penalty, especially if the advice is to act improperly. Mr. Fox is ultimately responsible for his actions.

153 It appears, however, that Mr. Fox's advisors did not advise him to commit the violations in this case. In fact, when Ms. Parker became aware that deposits were not being made into the Docket 010961 Account, she called the Company to urge deposits be made as required by the Order Approving Settlement Agreement.²⁶⁷ In addition, Mr. Fox was advised that he should not use the Docket 010961 Account money to pay AWR's tax obligations.²⁶⁸ Mr. Fox was solely responsible for deciding to violate the Commission's Order. Consultation with advisors is not a mitigating factor justifying reducing or eliminating the penalty.

²⁶⁵ Fox, Ex. 120T at 46:9-11.

²⁶⁶ Fox, Tr. 240:17-25.

²⁶⁷ Parker, Tr. 200:15-19. Mr. Finnigan concurred in that advice. *See* Fox, Tr. 301:1-21.

²⁶⁸ Fox, Tr. 301:22 to 302:8.

B. Staff Did Not Cause the Violations

154 Mr. Fox contends that Staff forced AWR into a situation where it had to
commit the violations.²⁶⁹ This simply is not the case.

155 AWR presented certain proposals to Staff regarding what to do with the
Docket 010961 Account once View Royal was sold.²⁷⁰ Staff did not support any of
the proposals brought to it, and Staff informed AWR of its position.²⁷¹ Staff is not
required to adopt any proposal by a utility that it feels is not in the public interest.

156 Mr. Fox could have taken the proposals to the Commissioners, and AWR did
submit a request for modification on November 19, 2002.²⁷² Mr. Fox understands
the Commissioners, not Staff, ultimately decide how regulatory requirements are
applied to companies regulated by the Commission.²⁷³ Even so, Mr. Fox decided to
withdraw AWR's request to modify the Order Approving Settlement Agreement
preventing the Commission from addressing the issue.²⁷⁴ Mr. Fox's decisions lead
to the violations, and mitigation is not appropriate.

²⁶⁹ Fox, Ex. 120T at 46:23 to 47:1.

²⁷⁰ Parker, Ex. 100T at 32:12-18.

²⁷¹ Eckhardt, Ex. 30T at 37:11-13.

²⁷² Parker, Tr. 193:6-9 and 194:2-5; Ex. 140.

²⁷³ Fox, Tr. 241:1-5.

²⁷⁴ Parker, Tr. 194:6-11; Ex. 141.

C. Violations Were Not Inevitable

157 Mr. Fox states he had no choice but to violate the Order Accepting Settlement Agreement.²⁷⁵ He argues the violations involving failure to deposit funds occurred because AWR did not have funds available.²⁷⁶ To the contrary, AWR had the funds to deposit into the Docket 010961 Account because \$4.40 from every customer bill was earmarked specifically for the Account. AWR billed and collected the \$4.40 from customers each month.

158 In addition, Mr. Fox claims the violations involving unauthorized use of funds occurred because AWR did not have money to pay certain tax liabilities.²⁷⁷ The tax liabilities paid from the Docket 010961 Account were capital gains tax on View Royal and income tax on the money accumulated in the Docket 010961 Account.

159 First, capital gains tax on View Royal should have been paid from the sales proceeds. Spending the entire amount of the proceeds was imprudent, regardless of the purpose. Moreover, spending the entire amount of the proceeds does not justify using funds from the Docket 010961 Account for unauthorized purposes. Had Mr. Fox acted prudently, he would have had the funds available.

²⁷⁵ Fox, Ex. 120T at 46:12-13.

²⁷⁶ *Penalty Assessment Against Virgil R. Fox, President, American Water Resources, Inc.*, Docket No. UW-031596, Application for Mitigation of Penalties.

²⁷⁷ *Id.*

160 Second, the tax paid on funds accumulating in the Docket 010961 Account
should not have been incurred. Not only did Mr. Fox allow the money to
accumulate, but he also allowed AWR to prematurely incurred the tax liability.²⁷⁸

161 AWR's cash flow problem stemmed largely from Mr. Fox's shortsighted
decision to sell View Royal, which resulted in a net decrease of \$12,000 to \$13,000 in
AWR's average monthly revenue.²⁷⁹ The sale also resulted in higher per-customer
fixed costs.²⁸⁰ Mr. Fox was aware of those consequences before executing the sale.²⁸¹

162 If the sale of View Royal altered AWR's structure to the extent that rates
were not adequate, he should have sought rate relief by either asking the
Commission to amend the Order Accepting Settlement Agreement or filing a rate
case. He had options available to him other than violating the Commission's Order.
Because Mr. Fox chose instead to violate the Commission's Order and mismanage
the Docket 010961 Account, the Commission should deny Mr. Fox's request for
mitigation. The Commission should order Mr. Fox to pay the entire amount, \$3,700,
within 15 days of entering the final order.

²⁷⁸ AWR's tax liability on the Docket 010961 Account funds is discussed above in section III.A. See *Florida Progress Corp. and Subsidiaries v. Commissioner of Internal Revenue*, 114 T.C. 587 (2000); *Mutual Tel. Co. v. United States*, 204 F.2d 160 (1953).

²⁷⁹ Ward, Ex. 41T at 37:8; Parker, Ex. 100T at 30:19 to 31:1.

²⁸⁰ Fox, Ex. 120T at 40:14-15.

²⁸¹ Fox, Tr. 283:3-19.

V. CONCLUSION

163 The records supports Staff's recommendation that the Commission order AWR to lower its rates by \$100,555 annually. In addition, the Commission should deny Mr. Fox's application for mitigation and order him to pay the full penalty amount.

DATED this 18th day of June, 2004.

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